

nondefense programs in order to achieve the \$144 billion deficit target. The actual size of the cuts required will, of course, depend on the average of the CBO and OMB deficit estimates, which will not be known until August 20.

SUMMARY TABLE 3. BUDGET PROJECTIONS, DEFICIT TARGETS,
AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars) <u>a</u>/							
Baseline Projections							
Revenues	734	767	828	915	987	1,067	1,148
Outlays	946	991	1,012	1,065	1,113	1,162	1,217
Deficit	212	224	184	150	127	96	69
Deficit Targets	n.a.	172	144	108	72	36	0
Baseline Less Targets	n.a.	52	40	42	55	60	69
Budget Resolution CBO Estimate	n.a.	n.a.	161	118	84	n.a.	n.a.
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	6.2	5.5	6.8	7.4	7.3	7.3	7.3
Real GNP, percent change	2.7	2.8	3.4	3.2	3.2	3.1	3.0
CPI-W, percent change	3.5	1.6	3.3	4.1	4.1	4.1	4.1
Civilian Unemploy- ment Rate	7.2	7.0	6.7	6.4	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.2	6.4	6.3	6.0	5.7	5.3

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

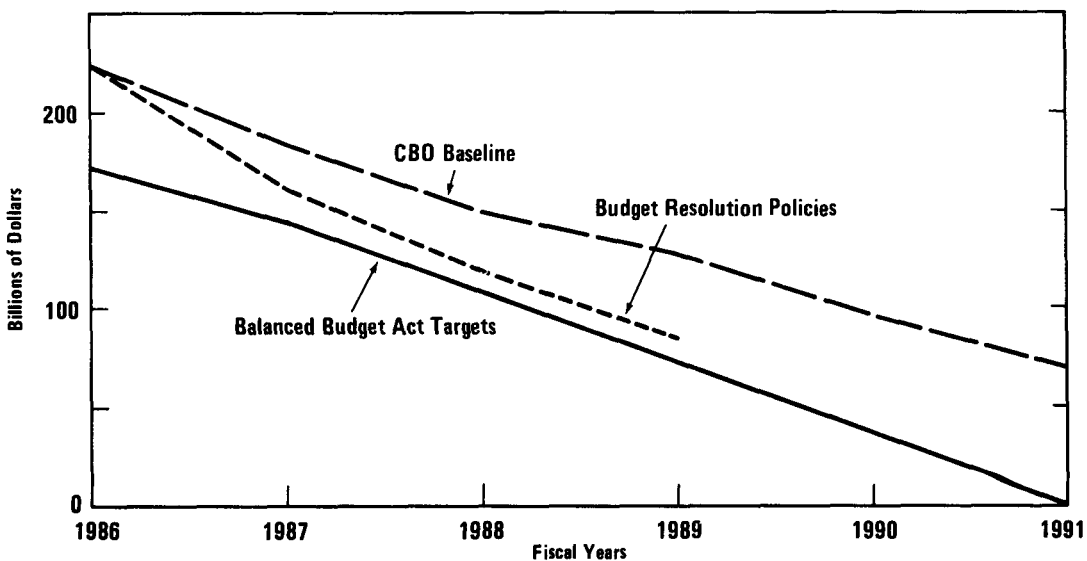
a. Includes Social Security, which is off-budget.

The immediate outlook for the deficit has worsened somewhat since February, when CBO projected baseline deficits of \$208 billion for 1986 and \$181 billion for 1987. The outlook for the 1988-1991 period, however, has become slightly brighter. This pattern of budgetary changes mirrors the revisions in the underlying economic assumptions. Lower real growth and inflation have reduced taxable incomes and significantly depleted expected revenues in 1986 and 1987. In later years, taxable incomes--especially corporate profits--are now projected to grow more rapidly, as should revenues. Baseline revenues grow from 18.7 percent of GNP in 1987 to 19.5 percent of GNP by 1991. By comparison, under CBO's February economic assumptions, taxes would represent 18.8 percent of GNP in 1987 but only 19.0 percent of GNP in 1991. Taken by itself, this increase in the projected ratio of taxes to GNP adds roughly \$30 billion to revenues by 1991. All in all, changes in the economic assumptions add \$7 billion to the estimated 1986 deficit and \$3 billion to the projected baseline deficit for 1987 but reduce the 1991 deficit projection by \$35 billion.

Aside from changes in the economic assumptions, other recent developments have had little effect on the baseline deficit projections. The

Summary Figure 3.

Baseline, Budget Resolution, and Target Deficits^a



SOURCE: Congressional Budget Office.

^aIncludes Social Security, which is off-budget.

enactment of new legislation, primarily the Consolidated Omnibus Budget Reconciliation Act of 1985, has reduced the deficit by \$5 billion in 1986 and an average of \$13 billion per year in the 1987-1991 period. Technical reestimates, however, have tended to increase the deficit. Higher spending for national defense, farm price supports, deposit insurance, and other federal programs and downward adjustments to revenue have added \$14 billion to the 1986 deficit and an average of \$12 billion annually thereafter. The net effect of legislative cuts and upward technical reestimates is to increase the 1986 deficit by \$9 billion and to reduce the baseline deficit by about \$1 billion per year in later years.

The same factors that have affected the baseline estimates also have caused the budget resolution deficits to change, although by differing amounts. As adopted by the Congress on June 26, the resolution showed deficits of \$143 billion in 1987, \$116 billion in 1988, and \$78 billion in 1989. Under CBO's updated economic and technical estimating assumptions, however, budget resolution policies would achieve deficits of \$161 billion in 1987, \$118 billion in 1988, and \$84 billion in 1989. While not quite meeting the Balanced Budget Act targets, these deficits represent reductions of \$23 billion, \$32 billion, and \$43 billion, respectively, in the 1987-1989 period compared with the CBO baseline.

CHAPTER I

THE ECONOMIC OUTLOOK

The Congressional Budget Office (CBO) projects that economic growth will pick up in the year ahead, with a steady decline in unemployment. Inflation rates are expected to increase as oil prices stabilize and the effects of rising import prices begin to spread through the economy. The prospects of lower federal deficits have paved the way for declines in the value of the dollar and in interest rates. Both of these forces should trigger more rapid growth in the near future, though at midyear economic conditions remained generally weak and there were few signs that the much awaited expansion had begun.

In the first half of 1986, the economy grew more slowly than CBO had projected last winter. Inflation was much lower than expected. The reasons why the outcome differed from the forecast are far from clear. One factor appears to have been business uncertainty over federal tax and spending policies. Another was the drop in oil prices, which fell by nearly 60 percent from their level in December. ^{1/}

In the areas of taxes and spending, the first six months of 1986 marked two important developments: the Congress debated a major tax reform bill, and the first spending cuts under the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act) took effect. While tax reform and deficit reduction are both expected to help the economy in the long term, both have created uncertainty that may have contributed to increased volatility and possibly to a temporary slowdown.

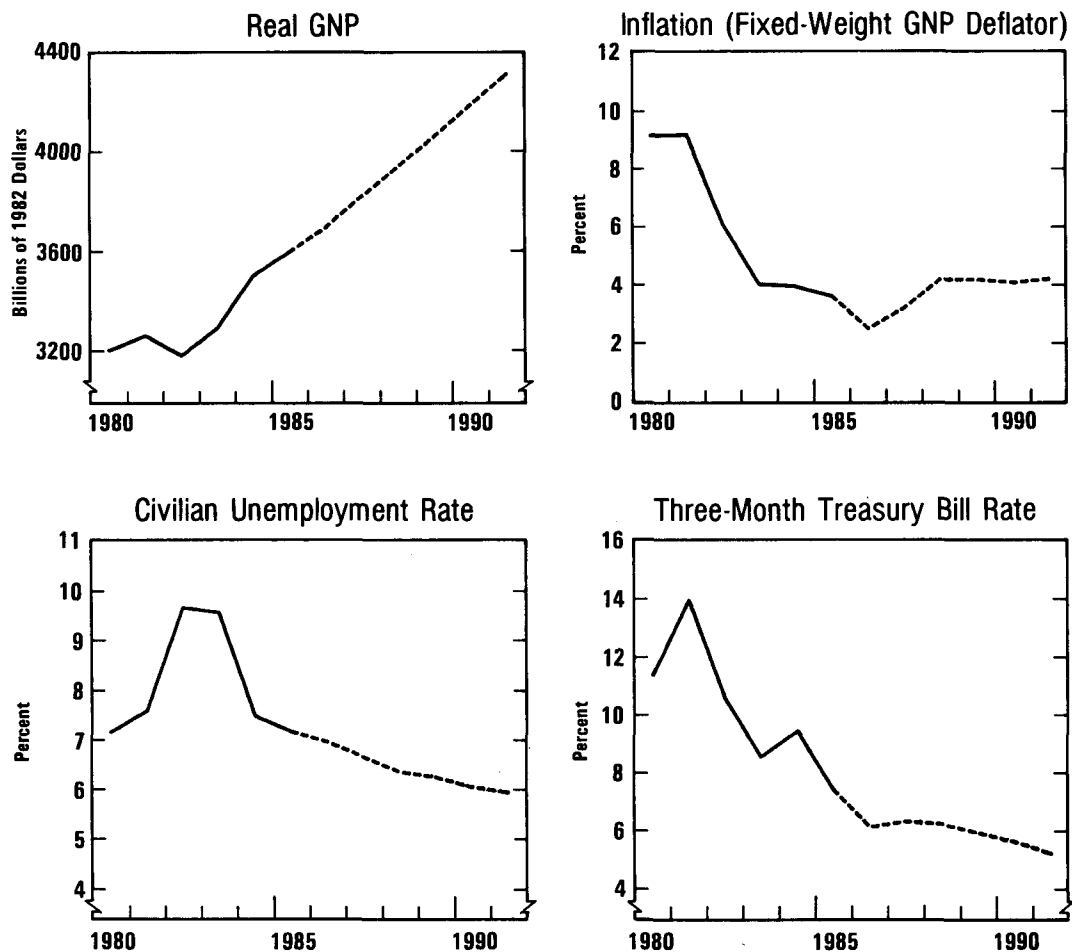
The sharp decline in oil prices, which was much larger than most analysts had anticipated, had mixed effects. In the 1970s, sharp rises in oil prices seemed to increase inflation and slow the economy simultaneously. In 1986, on the other hand, the reduction in oil prices brought inflation down, but the expected stimulus to growth was slow to develop. Moreover, the price drop had a devastating effect on the U.S. oil industry.

1. CBO had assumed an 18 percent decline in the refiners acquisition cost from December 1985 to July 1986.

THE ECONOMIC FORECAST AND MEDIUM-TERM PROJECTIONS

The CBO economic projections consist of two parts: a short-run forecast of economic conditions through 1987 that is conditional on specific policy assumptions, and a medium-term projection based on historical average growth rates (see Figure I-1).

Figure I-1.
Economic Assumptions



SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

The Short-Run Forecast

The short-run forecast is based on the following assumptions:

- o Federal tax and spending policies are assumed to satisfy the deficit requirements of the Balanced Budget Act;
- o The Federal Reserve Board is assumed to follow a policy that would allow M2 to grow at approximately the midpoint of its announced target range, provided that M2 velocity growth follows its past trends;
- o The world price of oil is assumed to remain close to \$12 per barrel through the end of 1987; and
- o The exchange rate (the Federal Reserve Board index) is assumed to continue to decline, though at a much lower rate than over the past year, reaching by the end of 1987 a level about 18 percent below its average at the end of 1985.

TABLE I-1. THE CBO FORECAST FOR 1986 AND 1987

	Actual		Forecast	
	1984	1985	1986	1987
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	8.5	6.3	5.3	7.5
Real GNP	4.6	2.9	2.9	3.5
Implicit GNP Deflator	3.6	3.3	2.4	3.9
CPI-W ^{a/}	3.3	3.2	1.2	4.0
Calendar-Year Averages (percent)				
Civilian Unemployment Rate	7.5	7.2	7.0	6.7
Three-Month Treasury Bill Rate	9.5	7.5	6.2	6.4
Ten-Year Government Bond Rate	12.4	10.6	7.7	7.9

a. Consumer Price Index for urban wage earners and clerical workers.

Given these assumptions, real GNP in the fourth quarter of 1986 is projected to be 2.9 percent higher than in the fourth quarter of 1985, and to grow somewhat faster, 3.5 percent, in 1987 (see Table I-1). As a result of lower oil prices, inflation at the consumer level will be very low (below $1\frac{1}{2}$ percent) during 1986, but is expected to accelerate to the 4 percent range during 1987 as oil prices stabilize and as higher import costs resulting from the lower dollar begin to affect prices. The unemployment rate is expected to remain at 7 percent on average this year and to fall to 6.7 percent next year. Although the 3-month Treasury bill rate and the 10-year Treasury bond rate are expected to rise slightly in 1987 from current levels, the increase is expected to be less than the rise in inflation. As a result, real interest rates are expected to decline.

Household spending should be supported in the year ahead by three factors: the decline in interest rates, low inflation, and the huge rise in the value of financial assets over the past year. The interest-rate decline and increased demand are also expected to generate an eventual resumption in the growth of producers' durable equipment investment. In contrast, real government purchases of goods and services are expected to be reduced under the constraints of the Balanced Budget Act.

In sum, CBO expects the economy to strengthen in the year ahead. The short-run adverse effect of the fall in oil prices on oil field activity should constitute a smaller drag in coming months; interest rates have remained low relative to their 1985 levels; and there are signs that the deterioration in net exports is coming to an end. Forecasts made at this time, however, are subject to an unusual number of uncertainties. Recent months have included abnormal volatility in commodity, money, and foreign exchange markets. This volatility presents difficulties to the forecaster in projecting the near-term outlook for oil prices, prices of agricultural products, interest rates, and exchange rates--all of them crucial ingredients of the forecast. In addition, the volatility is itself a reflection of more fundamental uncertainties that affect both financial markets and the rest of the economy. These fundamental uncertainties include:

- o The effects on the economy of the restrictive shift in fiscal policy mandated by the Balanced Budget Act;
- o The effects of the tax reform now under consideration, which could change the composition and sources of federal receipts and alter incentives for economic activities such as saving, working, investing, and owning homes;
- o The actions of the OPEC oil producers in the face of current low prices;

- o The speed with which the decline in the value of the dollar works to improve the real trade balance;
- o The risk to U.S. exports if economic growth abroad remains weak, thereby offsetting the beneficial effects of depreciation of the dollar; and
- o The effect of relatively high household and business debt, which could cause a sudden retrenchment of spending.

There is much controversy about the short-run impact of the large tax-law changes now being negotiated in the Congress. CBO's forecast does not explicitly include these changes. It is likely, however, that private plans already reflect in broad outline the main provisions that will emerge, and CBO's forecast takes into account indications of private plans such as the various surveys of investment intentions, as well as more indirect indicators such as the reaction of money and commodity markets.

Medium-Term Projections

CBO's revised medium-term projections for the years 1988 through 1991, presented in Table I-2, are constructed from historically based rules of thumb. Real gross domestic product (GDP) is assumed to grow over the period at a rate of about 3.2 percent, which was the average real GDP growth rate for the years 1948 through 1985. This path for real GDP, in conjunction with an estimated "Okun's Law" relationship between real gross national product (GNP) growth and unemployment, brings the unemployment rate down to 6 percent by the beginning of 1991. For the remainder of the projected period, real GNP is assumed to increase at a rate that keeps the unemployment rate at 6 percent. ^{2/} The still large current account deficit will reduce net U.S. holdings of foreign assets, and thus the flow of net income from abroad. GNP, which differs from GDP by the amount of these foreign earnings, is therefore expected to grow a bit more slowly than GDP. The inflation rate as measured by the GNP deflator is assumed to remain constant at a rate of 4.1 percent, which is very slightly below its long-term average in the years 1948 through 1985. Interest rates are assumed to decline to 1991 levels that will approximate historical averages for both the real short rate and the nominal spread between short and long rates.

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2. The rules of thumb used in these projections differ slightly from those used in the projections published in CBO's annual report last February. The February report used a different, and more complex, rule of thumb for projecting real GNP growth that was sensitive to the stage of the business cycle. The current, simpler rule, which applies the historical average GDP growth rate to the projections from 1988 to 1991, performs better in tracking historical growth patterns than the rule used last February.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS
FOR CALENDAR YEARS 1988-1991

Economic Variable	Actual	Forecast		Projected			
	1985	1986	1987	1988	1989	1990	1991
GNP (billions of current dollars)	3,998	4,218	4,504	4,838	5,193	5,575	5,975
Nominal GNP Growth (percent change)	6.2	5.5	6.8	7.4	7.3	7.3	7.2
Real GNP Growth (percent change)	2.7	2.8	3.4	3.2	3.2	3.1	3.0
Implicit GNP Deflator (percent change)	3.3	2.7	3.3	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.5	1.6	3.3	4.1	4.1	4.1	4.1
Civilian Unemployment Rate (percent)	7.2	7.0	6.7	6.4	6.3	6.1	6.0
Three-Month Treasury Bill Rate (percent)	7.5	6.2	6.4	6.3	6.0	5.7	5.3
Ten-Year Government Bond Rate (percent)	10.6	7.7	7.9	7.6	6.9	6.1	5.7
Corporate Profits (percent of GNP)	7.0	7.3	7.4	7.3	7.3	7.3	7.4
Wage and Salary Disbursements (percent of GNP)	49.2	49.3	49.4	49.4	49.5	49.6	49.6
Other Taxable Income (percent of GNP)	20.4	20.3	20.3	20.2	19.9	19.5	19.2

SOURCE: Congressional Budget Office.

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS
FOR FISCAL YEARS 1988-1991

Economic Variable	Actual	Forecast		Projected			
	1985	1986	1987	1988	1989	1990	1991
GNP (billions of current dollars)	3,938	4,164	4,423	4,753	5,102	5,477	5,876
Nominal GNP Growth (percent change)	6.7	5.8	6.2	7.5	7.3	7.3	7.3
Real GNP Growth (percent change)	3.1	2.8	3.2	3.3	3.1	3.1	3.1
Implicit GNP Deflator (percent change)	3.4	2.9	2.9	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.6	2.1	2.6	4.1	4.1	4.1	4.1
Civilian Unemployment Rate (percent)	7.3	7.1	6.8	6.4	6.3	6.1	6.0
Three-Month Treasury Bill Rate (percent)	7.9	6.5	6.3	6.3	6.2	5.8	5.4
Ten-Year Government Bond Rate (percent)	11.1	8.3	7.7	7.8	7.1	6.3	5.8
Corporate Profits (percent of GNP)	7.0	7.2	7.4	7.4	7.3	7.3	7.4
Wage and Salary Disbursements (percent of GNP)	49.1	49.2	49.3	49.4	49.5	49.6	49.6
Other Taxable Income (percent of GNP)	20.4	20.3	20.2	20.3	19.9	19.6	19.3

SOURCE: Congressional Budget Office.

The Tax Base. Projections of federal revenues depend in part on how wages, profits, and other incomes are assumed to behave (see Table I-2). Taxable wages should grow slightly faster relative to GNP during the next few years for two reasons:

- o Many analysts believe that the rise in the dollar between 1980 and 1985 worked to hold down wages, especially in tradeable goods industries: the decline in the dollar and consequent projected improvement in net exports is expected to permit stronger wage growth; and
- o The growth of nontaxable fringe benefits (pensions, health insurance contributions, and so forth) relative to wages appears to have stopped, and consequently taxable wages should grow as fast as compensation. ^{3/}

Lower interest rates and a slowing of the growth of the federal debt will mean a relative decline in personal interest payments, a major component of other taxable income in Table I-2. Profits will tend to be held back by higher real wage growth, and by the increase in employers' contributions for social insurance slated for 1988, but will be increased by the reduction of interest expense and by reduced foreign competition as the dollar falls. On balance, the profit share in 1991 is expected to be somewhat above the rate expected for this year.

RECENT ECONOMIC DEVELOPMENTS

Real GNP growth in the first half of 1986 was uneven but averaged only 2.4 percent, little changed from its sluggish 2.7 percent growth in 1985 (see Table I-4). Industrial production actually declined at a 1.2 percent annual rate in the first two quarters of this year, after rising 2.2 percent in 1985. The industrial capacity utilization rate reflected this weakness, registering below 79 percent in June compared with 80 percent for the fourth quarter of 1985. The overall unemployment rate rose slightly, primarily as a result of weakness in the goods-producing sectors, although employment growth remained strong in the service sector.

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3. One of the major sources of relative growth in fringe benefits, that of health care insurance, appears to have been checked in recent years. The growth in pension plan assets resulting from the stock market's rise has recently permitted employers to reduce contributions or to reorganize plans, in effect extracting their previous contributions. This practice may not continue. Nontaxable fringe benefits may also begin to grow again as a result of the increasing prevalence of 401K plans, which give employees the option of converting taxable wages into tax-deferred pension contributions. The expected growth of these plans, which is not incorporated in the economic projections, has been taken into account in computing revenue projections.

The decline in industrial production in the first half was partially a reflection of the collapse of petroleum drilling. But even if the mining sector is excluded, industrial production has not grown. Large trade deficits have continued to dampen the growth of manufacturing output. In contrast to the manufacturing and mining sectors, the construction and the service-producing sectors of the economy have been strong. As a result, in the first half of 1986, the growth rate of total payroll employment eased only slightly from the 3.3 percent rate of 1985.

The pace of growth from quarter to quarter has also been quite uneven. After increasing at a 3.8 percent rate in the first quarter of this year, real GNP grew at only a 1.1 percent rate in the second quarter. The components of GNP, however, behaved in ways that make it difficult to say whether the slowdown is an indication of continuing weakness. For example:

- o Consumer spending rose at a 5.9 percent rate in the second quarter, a growth rate that is not likely to be sustained;
- o Oil imports volume surged in the second quarter because of increased demands and because oil inventories had been drawn down sharply in the first quarter. This surge reduced net exports by about \$16 billion (in 1982 dollars) in the second quarter. Although high levels of oil imports are expected to continue, another surge is not anticipated in the third quarter;

TABLE I-4. RECENT MEASURES OF AGGREGATE ECONOMIC ACTIVITY (Percent change at annual rates)

	1984	1985	1985				1986	
			I	II	III	IV	I	II
Real GNP	6.4	2.7	3.1	2.3	4.1	2.1	3.8	1.1
Real Final Sales ^a /	4.4	3.5	4.1	3.2	5.0	0.4	1.6	4.0
Industrial Production	11.5	2.2	2.3	1.3	1.9	1.9	0.5	-3.0
Industrial Production (Less Mining)	11.9	2.6	1.6	1.5	2.8	2.4	1.4	-1.5
Payroll Employment	4.8	3.3	2.8	3.0	2.5	3.2	3.0	1.8
Unemployment Rate	7.5	7.2	7.3	7.3	7.2	7.0	7.1	7.2

a. Excluding Commodity Credit Corporation (CCC) purchases.

- o Real government purchases of goods and services (excluding Commodity Credit Corporation purchases) grew by 13 percent, led by a 16 percent jump in defense, and a 51 percent jump in state and local structures. It is unlikely, however, that these growth rates will continue;
- o Auto production was cut back sharply in the second quarter to reduce excessive inventories (thereby reducing GNP growth by 0.7 percentage point). Current production schedules (seasonally adjusted) call for a substantial increase in auto production this quarter from the second-quarter levels.

Labor Markets

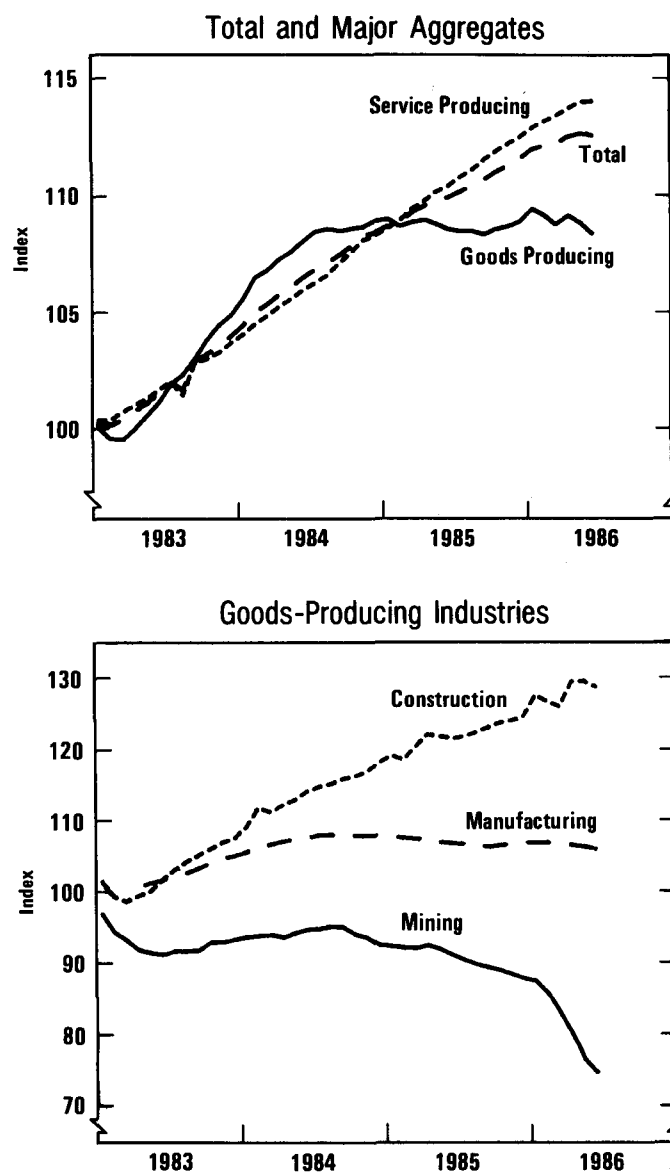
Labor markets continued to be soft in the first half of the year, and the unemployment rate for the civilian labor force fluctuated narrowly about 7 percent. Wage gains were very moderate, and productivity growth continued to be disappointing.

Employment. The demand for labor grew somewhat more slowly during the first half of the year than in the second half of 1985. Payroll employment, after accounting for striking workers, grew an average of approximately 140,000 jobs per month from January to June, compared with 270,000 per month in the previous half-year. These aggregate figures masked major disparities among industries. Manufacturing payrolls fell by roughly 110,000 from January to June, after adjusting for strikes. Most of that decline was concentrated in durable goods industries and the sharpest employment declines came in mining, specifically in oil and gas extraction (see Figure I-2). Payrolls in oil and gas extraction in June were down about 113,000 from the level in January--a decline of roughly 20 percent. (That industry has lost nearly 320,000 workers since its employment peak in March 1982.) In contrast to the loss of jobs in durable goods manufacturing and mining, employment continued to grow strongly during the first half of the year in construction and in most of the service-producing industries.

Labor Force and Unemployment. If employment growth in the first half was relatively sluggish, growth in the labor force was not. The civilian labor force grew by 1.3 million people from January to June and by 3.1 million from June 1985 to June 1986, with women accounting for the bulk of this employment growth. In that period, the number of adult women in the labor force grew by about 1.6 million.

Unemployment in the civilian labor force edged up from an average of 7.0 percent in January-February to 7.2 percent in May-June--thus reversing the declines in unemployment during the second half of 1985 (see Figure I-3). As this report was going to press, the rate edged down to 6.9 percent in July. In June, the unemployment rate for adult men was only slightly below that of adult women--6.2 percent versus 6.4 percent. The rate for

Figure I-2.
Payroll Employment



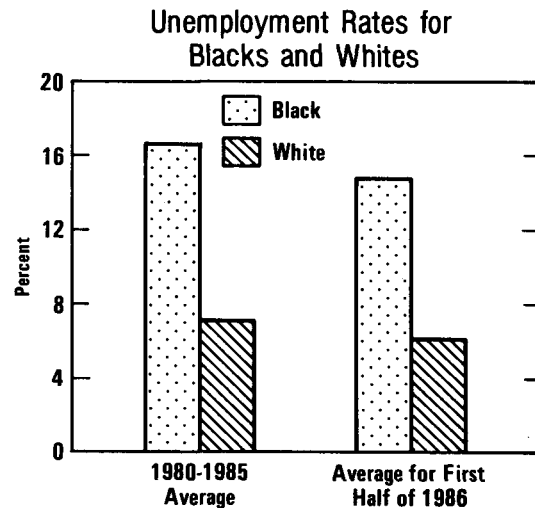
SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

NOTE: All employment series are indexed, November 1982 = 100.

adult males was up about four-tenths of a percent from January-February to May-June, compared with a rise of about one-tenth of a percent for adult women--reflecting the weakness in the goods-producing sector. The teenage unemployment rate was about 19 percent in May-June, slightly higher than at the beginning of the year. The unemployment rate for black workers remained about $2\frac{1}{2}$ times higher than that for white workers (in June, 15.1 percent compared with 6.1 percent).

The collapse of the oil industry was reflected in very high unemployment in the mining industry--17.6 percent in June compared with

Figure I-3.
Civilian Unemployment Rates



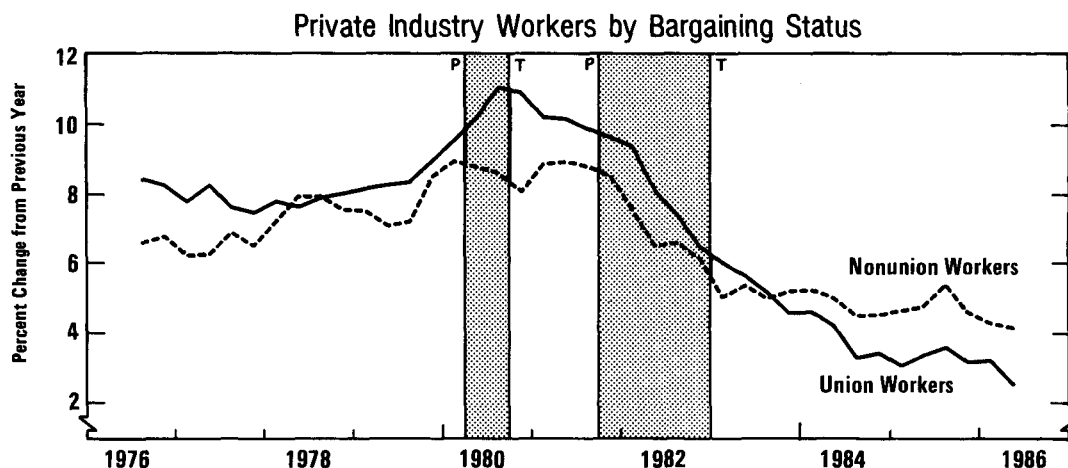
SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

10.9 percent a year ago. The effect was concentrated in energy-producing states such as Texas, which had an unemployment rate of 10.5 percent in June compared with 7.1 percent a year ago. By contrast, unemployment in some areas of the country, particularly in the East, was quite low. For instance, Massachusetts' unemployment rate in June was 3.6 percent.

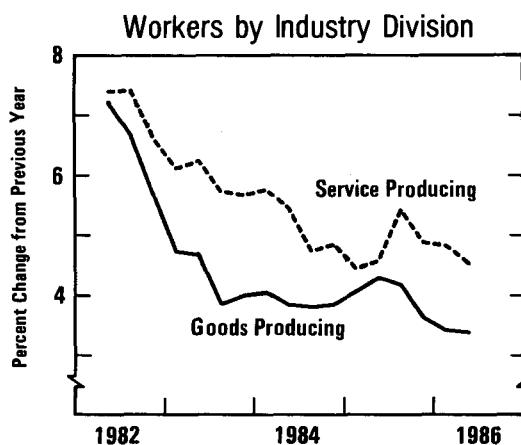
Wages. Recent data suggest that money wage increases have moderated further. The index of average hourly earnings in the second quarter of this year was only 2.5 percent above the level of a year ago. The employment cost index, a more comprehensive measure, showed somewhat larger gains, though these were only moderate (see Figure I-4). In the second quarter,

Figure I-4.

Employment Cost Index, Wages and Salaries



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

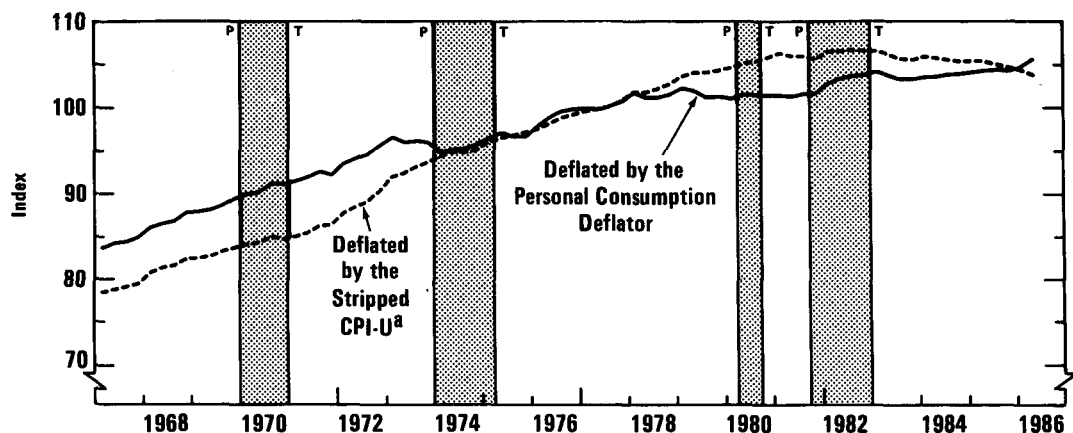


the cost index for total compensation was up 4.0 percent from the level of a year ago. Wage increases were running higher for nonunion than for union workers and higher in service-producing industries than in goods-producing industries. But there was no acceleration in wages, even in nonunion and service industries. Before 1985, wage and salary increases understated cost pressures because fringe benefits were rising more rapidly than wages and salaries. Beginning in 1985, however, fringe benefits have been rising at roughly the same rate as wages and salaries.

Real wages--nominal wages adjusted for changes in the cost of living--have grown unusually slowly during most of the current expansion. In fact, were it not for the weakness of food and oil prices since 1983, real compensation per hour in the nonfarm business sector would have fallen since the last recession trough--see Figure I-5. With the recent fall in oil prices, however, the Consumer Price Index has actually declined moderately, which has helped to boost real wages. This improvement in real wages has in turn helped to spur strong consumer spending.

Unions have been settling for unusually low wage increases in contract negotiations. Major private union settlements in the first half of 1986 provided increases of 1.2 percent in the first year and 1.9 percent annually

Figure I-5.
Real Compensation Per Man-Hour



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, Department of Labor; Bureau of Economic Analysis, U.S. Department of Commerce.

^aCPI-U less food, energy, and used cars.

over the life of the contract (not including automatic cost of living adjustments). The last time the same parties bargained (generally two to three years ago), average wage adjustments were 2.5 percent in the first year and 3.1 percent annually over the contract life.

Several factors have been instrumental in bringing about much lower wage increases: continued slack in labor markets, slower increases in the cost of living, more intense competitive pressures in markets for tradeable goods, and intensified competitive pressures in recently deregulated industries. Most forecasters foresee a mild acceleration in wages during the next two years, primarily because labor markets are expected to tighten and the moderating effect of commodity prices will be largely temporary. Moreover, the projected turnaround in the U.S. international competitive position could put an end to severe downward wage pressure in a number of manufacturing industries.

Productivity and Unit Labor Costs. Productivity growth in the nonfarm business sector has continued to be erratic on a quarter-to-quarter basis, and disappointing overall (see Figure I-6). Nonfarm business productivity increased only 0.5 percent in 1985. But in the manufacturing sector, available data suggest that productivity growth has been much more encouraging, in part because of increased foreign competition. ^{4/} This has been offset, however, by extremely poor performance in the nonmanufacturing (nonfarm) sector, the reasons for which are not well understood.

The combination of moderate wage growth and relatively flat productivity meant that unit labor costs grew at roughly a 2 percent to 4 percent rate in recent quarters (see Figure I-6). In manufacturing, cost pressures have been considerably lower than in the nonfarm business sector as a whole because of lower wage gains and higher productivity growth.

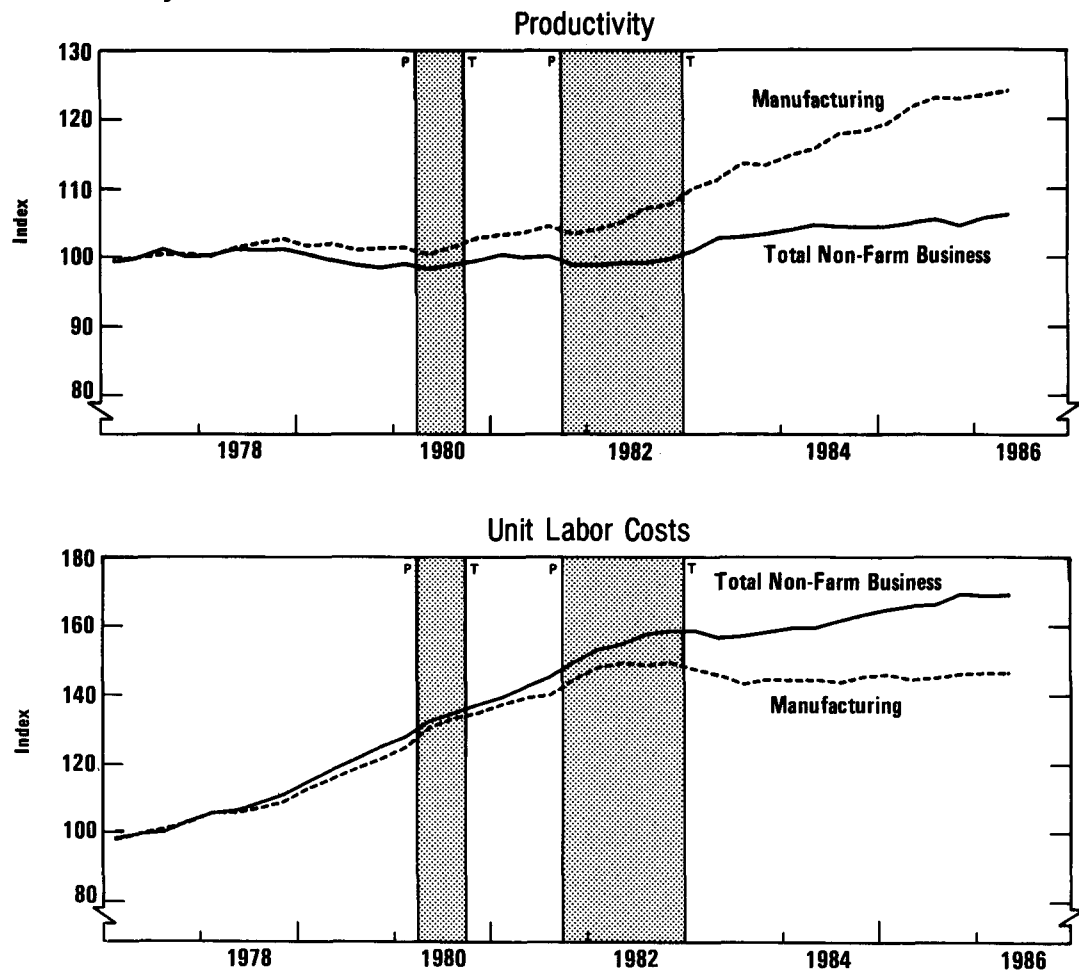
Inflation Update

Prices have risen much less in the last half year than was anticipated for several reasons. The decline in the price of oil was unexpectedly large. The sharp drop in the value of the dollar has so far increased import prices less than had been expected. Food price increases have remained moderate. As a result, the Consumer Price Index fell for three months this spring, for the first time since 1954.

4. Data on recent productivity trends in manufacturing and (nonfarm) nonmanufacturing are subject to wide margins of error.

Some prices have moved contrary to this general trend: if prices of food, energy, and used cars are excluded from the measure of price increase, the rate of consumer price inflation has remained stubbornly at around 4 percent (see Figure I-7). Prices of services in particular, which are not subject to foreign trade pressures as much as those of goods, have

Figure I-6.
Productivity and Unit Labor Costs



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

TABLE I-5. INFLATION (Percent change, fourth quarter to fourth quarter, unless otherwise noted)

	1982	1983	1984	1985	1986 ^{a/}	
					I	II
Fixed-Weight GNP Deflator	5.0	3.9	3.9	3.6	2.5	1.8
Deflator for Imports	-1.7	-2.1	-0.5	-1.0	-7.0	-14.6
Deflator for Goods Imports Excluding Petroleum	-2.3	-1.7	-1.2	-1.1	2.1	4.6
Consumer Price Index (CPI) for All Urban Consumers ^{b/}	5.3	3.8	4.1	3.5	1.4	-1.7
Stripped CPI ^{c/}	6.2	4.3	4.5	4.5	4.2	4.5
Producers Price Index (PPI), Finished Goods	3.6	0.8	1.7	1.6	-7.8	-5.4
PPI, Crude Materials	-0.8	4.1	-1.2	-6.1	-19.3	-21.4
PPI, Crude Nonfood Materials Less Energy	-9.7	13.4	-2.1	-4.3	-4.3	7.6
PPI, Refined Petroleum Products	-6.0	-9.3	-4.6	-1.7	-53.4	-65.8
CPI for Food at Home	2.6	1.4	3.8	1.4	1.5	0.4
CPI for Energy	1.9	-1.5	0.3	0.9	-15.2	-35.2

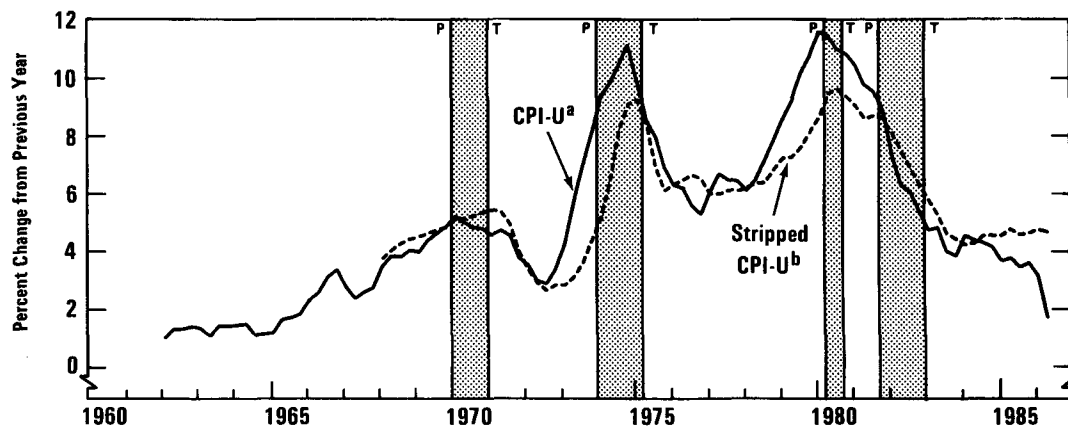
SOURCE: Bureau of Labor Statistics, U.S. Department of Labor.

a. Annualized quarterly rates.

b. The Consumer Price Index (CPI) is published in two versions: the CPI-U for all urban consumers, shown here, and the CPI-W for urban wage and clerical workers, shown in the projections in Table I-2. Before 1983, both measures used a flawed measure of the cost of homeownership; this was corrected in 1983 for the CPI-U, reported here, and in 1985 for the CPI-W. The CPI growth rates for the 1980-1982 period reported here are those of an experimental CPI measure that approximates the current CPI treatment of homeownership.

c. CPI less food at home, energy, and used cars.

Figure I-7.
Measures of Inflation



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

^aCPI-U from January 1983 to the present, prior to that time a CPI measure that is conceptually similar to the current CPI-U treatment of homeownership.

^bCPI-U less food, energy, and used cars.

continued to move up at about a 5 percent rate, paralleling the similar divergence in wage growth between manufacturing and services. ^{5/}

Commodity Prices. Recent overall price trends have been dominated by lower prices for crude materials, led by the dramatic fall in oil prices. The decline in the price of crude oil by nearly 60 percent since late 1985 can be largely attributed to increases in the production of oil by Saudi Arabia. In an attempt to increase its share of the world market, Saudi Arabia has more than doubled its production level since last summer. Since non-OPEC production has not fallen and world demand for oil has not increased enough to absorb the resulting oversupply, the Saudi strategy has forced a large fall in the price of oil. Reports that OPEC is raising output even further suggest that prices are likely to stay low in the near future. If, as expected, the current trends in world demand and non-OPEC supply continue through 1987, any major increase in the price of oil next year will require that OPEC countries significantly reduce their production levels.

5. One of the most important factors has been the increase in housing costs, up about 6 percent over the past year and over 5 percent (at an annual rate) in the first half of 1986. Medical care, a smaller component, has increased even more, at about a 7½ percent rate over the past year and over 8 percent in the first half of 1986.

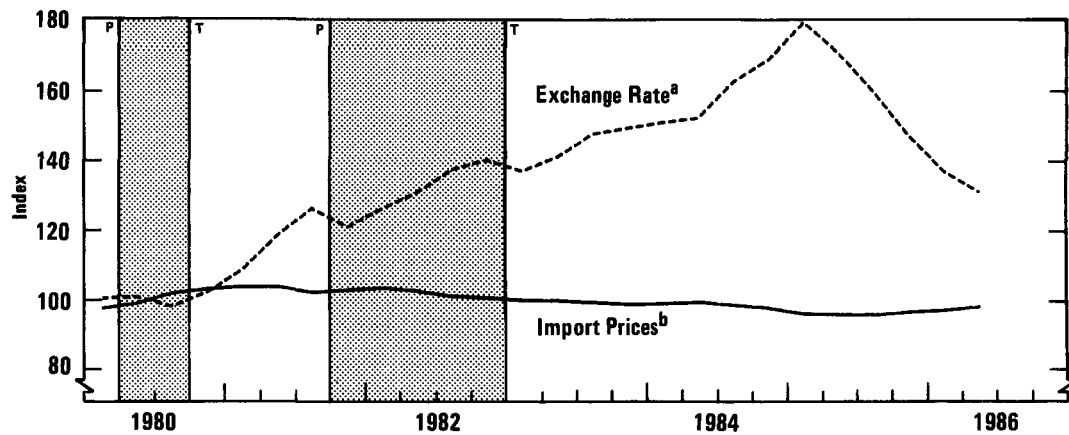
Prices of most other commodities used as inputs to production have also been weak over the last six months. Prices of agricultural crops have been relatively steady, for the most part, as their downward trend was stabilized by government price supports. But significant reductions in most of these support prices this summer and fall will further depress prices for most crops. Meat and poultry prices have been weak over the first half of the year, partly because of the effect on beef prices of the Dairy Termination Program. Expected declines in beef production and higher poultry demand over the next several quarters may push these prices upward somewhat, but not enough to increase food prices significantly at the retail level.

The oil price decline should continue to work to reduce inflation for some time, as lower energy prices are passed through into lower prices of other goods. But as the impact of this decline wears off, the effect of the exchange rate decline will begin to be felt throughout the price structure, pushing up the rate of inflation to an uncertain extent. Some analysts believe that the recent rapid growth of the money supply could support a substantial increase in inflation, particularly if there is a tightening in labor and product markets. Factors working in the opposite direction are the still-high unemployment rate and low capacity utilization in manufacturing.

Exchange Rates. Commonly-used estimates suggest that a 10 percent decline in the dollar might add at least 1 percent to the level of U.S. consumer prices by the time it has been fully passed through. In recent years, the dollar's rise worked to hold down consumer prices, but no longer. So far, import prices appear to have responded less than usual to the drop in the trade-weighted value of the dollar (see Figure I-8). One reason is that while the dollar has fallen sharply in the last five quarters against the yen and European currencies, it has not changed by much against the currencies of Canada, Latin America, and the Pacific rim countries which supply a very large share of U.S. imports. Furthermore, even prices of imports from Japan and Western Europe have not increased nearly as much as the depreciation of the dollar against the currencies of those countries would suggest.^{6/} This delay, or possible attenuation, in import price response to

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6. According to the Federal Reserve Board (FRB) exchange rate index--a commonly used measure--the dollar has depreciated by about 30 percent since its peak in February 1985. This change exaggerates the expected loss in competitiveness of imports relative to American products. The composition of the FRB index gives predominant weight to the currencies of the major European countries and Japan, against which the dollar has depreciated significantly, and little or no weight to such important U.S. trading partners as Canada and the developing countries, against whose currencies the dollar has remained relatively stable. Nevertheless, even a broader measure of the dollar's international value, which would show a smaller depreciation of the dollar from its peak, would still lead one to predict a substantial increase in import prices. Yet, nonoil import prices have increased by only a few percentage points over the last four quarters.

Figure I-8.
Exchange Rate and Import Prices



SOURCES: Congressional Budget Office; Federal Reserve Board; Bureau of Economic Analysis, U.S. Department of Commerce.

^aFederal Reserve Board exchange rate index.

^bImplicit price deflator for nonpetroleum merchandise imports.

the depreciation appears to be partially explained by adjustments in profit margins of Japanese and European exporters and U.S. distributors.^{7/} Another factor moderating the overall response of nonoil import prices to the depreciation is that depressed market conditions have dampened prices for several important sub-groups of nonoil imports, particularly many crude and intermediate materials and components for computers, overwhelming the effects of the depreciation of the dollar.

If the United States is to achieve a substantial improvement in its foreign trade balance, prices of imports will have to rise considerably above their present levels. Such a rise would tend to increase inflation, at least for a time, especially as measured by the Consumer Price Index. (The CPI, which includes imported goods, would be affected more than the GNP de-

7. During the period of dollar appreciation, and particularly at the time of the sharp spike in the value of the dollar that occurred in late 1984 and early 1985, foreign exporters and U.S. importers allowed their profit margins to increase abnormally, because they expected the dollar appreciation to be temporary. As the dollar fell, these businesses could afford to protect their market shares by allowing profit margins to fall back to more normal levels before raising prices. If the dollar prices of most Japanese and European goods do eventually rise, imports from Japan and Europe may be in part replaced by less expensive imports from countries whose currencies have not appreciated relative to the dollar.